

**F. HODGE O'NEAL**  
**CORPORATE AND SECURITIES LAW**  
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**STATE AND FEDERAL REGULATION OF**  
**CORPORATE TAKEOVERS: A VIEW**  
**FROM THE DEMAND SIDE**

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**INTRODUCTION**

The study of corporate law stands at an important crossroads. Recent events have brought into sharp focus a variety of unanswered questions and interesting and important contradictions inherent in much of the received wisdom about corporate governance. For example, it often is argued that corporate takeovers transfer wealth from firms' corporate stakeholders—particularly their bondholders and employees—to their shareholders.<sup>1</sup> On the other hand, it also is argued that the regulation of corporate takeovers under state law transfers wealth from shareholders to these very same stakeholders—bondholders and corporate employees.<sup>2</sup> It is mysterious why the shareholders should be so successful at effectuating intra-firm wealth transfers, and yet be so unsuccessful at accomplishing legislative wealth transfers.

Similarly, the received wisdom in corporate law is that Delaware has dominated the jurisdictional competition for corporate charters either by winning a "race for the bottom"<sup>3</sup> or else by winning a "race for the top."<sup>4</sup> These rival theories depict Delaware as "captured" by a single

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1. The principal exponent of this view has been Morey McDaniel. See McDaniel, *Bondholders and Stockholders*, 13 DEL. J. CORP. L. 205 (1988).

2. Coffee, *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1 (1986).

3. The phrase "race for the bottom" was coined by Professor William Cary. See Cary, *Federalism and Corporate Law Reflections Upon Delaware*, 83 YALE L.J. 663, 666 (1974). The phrase is derived from the dissenting opinion of Justice Brandeis in *Louis K. Liggett Co. v. Lee*, 288 U.S. 517, 557-60 (1933) (Brandeis, J., dissenting).

4. Winter, *State Law, Shareholder Protection and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 254 (1977).

interest group, either managers (as in the race to the bottom theory) or shareholders (as in the race for the top theory). These interest groups purportedly craft Delaware law to suit their own ends at the expense of all other interested groups. But Delaware's passage of a tough antitakeover statute has cast considerable doubt on the validity of the thesis that Delaware law reflects victory in a "race for the top" designed to maximize shareholders' wealth. And the failure of Pennsylvania to attract significant new chartering business as a result of its outrageously restrictive new antitakeover law casts equal doubt on the validity of the "race for the bottom" thesis. That thesis would predict that Pennsylvania, as the state with the most comprehensive array of defenses for incumbent management, should win the competition for corporate charters.

Perhaps the most glaring unanswered question in the dominant theoretical models of corporate law concerns the relationship between state and federal law. The statement that the internal rules of corporate governance are creatures of state law simply is no longer accurate. Federal administrative agencies, particularly the Securities and Exchange Commission (SEC or Commission) are increasingly willing to promulgate rules and render administrative decisions that encroach on the traditional province of state law by making significant incursions into the internal decisionmaking processes of individual firms.

This Article argues that the key to understanding the complex regulatory environment in which the modern United States corporation is forced to operate lies in understanding the nature of the underlying groups who stand to win or lose as that environment changes. It is the thesis of this paper that, while corporate law has always reflected the outcome of a competitive struggle among rival groups for preferential treatment in the regulatory process, in recent years the stakes involved in this struggle have risen dramatically as a consequence of the costs and benefits imposed on these groups by the market for corporate control. As those stakes have gone up, new groups have been induced to enter the regulatory fray. In particular, groups such as labor unions, the New York Stock Exchange (NYSE or Exchange), and even local groups, such as art museums and other civic organizations, have found it in their interests to make their voices heard by regulators.

This Article observes that these interest groups do not take their cases to a randomly selected group of regulators. Rather, these groups naturally seek hearings with those regulators that they believe will be most sympathetic and responsive to their viewpoints. Generally, a particular

interest group would prefer to deal with the regulators with whom it has established a preexisting relationship, or at least a pattern of repeated dealings. Sometimes these regulators happen to be state regulators, and sometimes these regulators turn out to be federal regulators.

Thus, this Article concludes that state and federal law in the takeover sphere has not developed in response to any coherent pattern or model that is consistent with the "public interest." Indeed, it is misleading to suggest that any sort of coherent "relationship" between state and federal law actually exists. Rather, both state and federal law reflect the outcome of struggles by rival interest groups, acting through their favored regulatory agencies, to obtain regulation that serves their own, private interests. The source of a particular rule or regulation is not determined on the basis of any neutral principle about the benefits of a local as opposed to a national rule. Rather, lawmaking bodies will issue regulations in response to the demands of their constituents, regardless of the implications of that regulatory solution for the relationship between state and federal law.

When a particular lawmaking body has numerous constituencies, the regulations it creates will reflect a compromise designed to maximize the aggregate political support available to the lawmakers from all relevant groups. Thus, the regulatory patterns simply will reflect the extent to which particular interest groups enjoy access to particular sources of law. When viewed from a public interest perspective, the sources of regulation that we observe may appear random or nonsensical. But when viewed from the perspective of the relevant interest groups, a rational framework for the pattern of regulation emerges.

Section I of this Article contains a discussion of the mechanics of interest group theory as that theory applies to corporate law. Section II illustrates the Article's thesis by examining three important sources of regulation in the market for corporate control: Congress, the SEC, and the states. First, I argue that Congress has responded to the increased political stakes associated with the modern market for corporate control by testing the regulatory waters. That testing triggered the dramatic stock market crash of October 1987, and caused Congress to conclude that the political costs of further regulation of the market for corporate control outweighed the gains.

Next, the SEC's role in the regulation of corporate takeovers is considered. The SEC regulates the market for corporate control in a number of ways, some subtle and some quite overt. But all of the SEC's regulations

of the market for corporate control respond to the preferences of a discrete interest group or groups. As with Congress and the SEC, state regulation of the corporate control market also is responsive to the demands of interest groups, but, as might be expected, the interest groups that dominate state legislatures not only differ from the interest groups that dominate the SEC, they also vary from state to state.

Finally, in Section III, the Article considers the Supreme Court's role in fashioning the ground rules that govern the market for corporate control. This section shows that the Court has decided not to impede the rather obvious attempts by certain states to interfere with interstate commerce. I will argue that the only plausible explanation for the Court's inactivity lies in its mysterious desire to protect Congress from the political costs of regulating a field in which the political costs of regulation are greater than the benefits of such regulation.

#### I. THEORETICAL UNDERPINNINGS: INTEREST GROUP THEORY

Interest group theory recognizes that the majority of government activity is devoted to the transfer of resources among citizens. Government is treated as a firm that supplies a product. That product is called legislation, and it is treated as a "good demanded and supplied much as other goods, so that legislative protection flows to those groups that derive the greatest value from it, regardless of overall social welfare . . . ."<sup>5</sup> According to interest group theory, individual citizens both supply laws, by paying taxes and bearing other regulatory burdens, and demand laws, by organizing into special interest groups in order to supply political support to politicians in exchange for legislation that transfers wealth to themselves from the politically powerless.

Interest group theory further posits that politicians maximize the aggregate political support they receive from all interest groups. At the margin, the legislature will enact a rule if the resulting gain in political support outweighs any expected loss in political support, either from the public or from a rival group. Thus, contrary to popular belief, interest group theory is "inconsistent with the rather primitive 'capture theory' of economic regulation which posits that one particular interest group rather than a group of interest groups drives legislation or regulation."<sup>6</sup>

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5. Posner, *Economics, Politics, and the Reading of Statutes and the Constitution*, 49 U. CHI. L. REV. 263, 265 (1982).

6. Macey, *Public Choice: The Theory of the Firm and the Theory of Market Exchange*, 74

According to the interest group theory of government, politicians maximize their political support both by acting as brokers among preexisting interest groups and by acting as entrepreneurs, creating new markets for their products:

As a broker, [a regulator] gains political support by transferring resources among the various groups in society. As an entrepreneur he seeks to create groups that he can benefit, in order to receive political support from them. [This] discussion implies not only that certain sorts of groups are more effective in obtaining desirable legislation, but also that certain sorts of issues will be most attractive to entrepreneurial politicians.<sup>7</sup>

The ability of individuals to organize into effective interest groups will be determined by their ability to overcome the information costs and organization costs that plague all individuals who attempt to seek favors from the government.<sup>8</sup> Information costs impede individuals who seek wealth transfers for two reasons. First, it is costly for an individual to identify and ascertain the effects that a particular issue will have on his welfare. Second, even when an individual knows the likely effects of an issue, it is costly for that individual to identify other similarly-situated individuals to join him in his quest for legislation.<sup>9</sup> As I have noted in another context:

[E]ven before we get to the issue of the relative efficiency of interest groups in the political sphere, we must realize that for most people it simply does not pay to become sufficiently well informed on most issues to have an opinion, much less to attempt the outcome. Where a piece of legislation will cost a taxpayer \$50.00 and the net cost of obtaining information about the effects of the legislation (including the opportunity costs of the taxpayer's time, and the start-up costs of identifying the issue) are greater than \$50.00, no rational taxpayer will obtain the information to begin to affect legislative outcomes.<sup>10</sup>

Another reason why individual voters, if they are rational, will refrain from wasting resources by informing themselves of the details surrounding the legislative process is that their votes do not matter. Individual votes do not matter because the probability that an individual's vote will

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CORNELL L. REV. 43, 46 (1988) (citing Posner, *Theories of Economic Regulation*, 5 BELL J. ECON. & MGMT. SCI. 335 (1974)).

7. *Id.* at 46.

8. R. MCCORMICK & R. TOLLISON, *POLITICIANS, LEGISLATION AND THE ECONOMY* 16 (1981).

9. *Id.* at 17.

10. Macey, *supra* note 6, at 47.

be decisive on a particular issue "is effectively zero."<sup>11</sup>

The way that individuals can effect legislative outcomes is by organizing into political coalitions or interest groups. Interest groups enable individuals to overcome the information costs that face individual voters. But some individuals organize into interest groups and others do not. This is because different individuals face different organization costs when they attempt to form political coalitions. In particular, if an individual already has joined a group for a nonpolitical reason, it will be relatively easy to turn that group into a political coalition. Examples of groups formed for nonpolitical purposes that have evolved into effective political coalitions include corporations, labor unions, and trade associations, such as the American Medical Association, the American Bar Association, and the American Association of University Professors.

These sorts of organizations "not only benefit their members by overcoming the informational problems faced by individuals in the political process, they also benefit their members by employing a variety of devices to mitigate the free-rider problems that inhibit the wealth transfer process."<sup>12</sup> The free-rider problem inhibits the wealth transfer process because individual members of interest groups have incentives to allow other group members to bear the costs of lobbying for wealth transfers, since these individuals will share any benefits obtained by their more industrious colleagues. Rational interest group members will anticipate this problem and devise a system of internal rewards and sanctions to cope with it.<sup>13</sup> The more effective the group is at overcoming its free-rider problems, the more successful it will be at obtaining wealth transfers.

The foregoing discussion has been a rather straightforward rendition of the economic theory of regulation.<sup>14</sup> This theory, which is now almost universally accepted among economists,<sup>15</sup> and is "[e]spoused by an odd mixture of welfare state liberals, muckrakers, Marxists, and free-market economists"<sup>16</sup> should by now be familiar to every law student interested in the operation of the regulatory state.

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11. Lee, *Politics, Ideology, and the Power of Public Choice*, 74 VA. L. REV. 191, 193 (1988).

12. Macey, *supra* note 6, at 48.

13. M. OLSON, *THE RISE AND DECLINE OF NATIONS*, 17-29 (1982).

14. For the more detailed treatments on which the foregoing discussion is based, see Macey, *supra* note 6.

15. Kalt & Zupan, *Capture and Ideology in the Economic Theory of Politics*, 74 AM. ECON. REV. 279 (1984).

16. Posner, *Theories of Economic Regulation*, 5 BELL J. ECON. & MGMT. SCI. 335, 335 (1974).

The economic theory of regulation is a "new development" that "already has begun to provide new insights into the role and effect of political institutions."<sup>17</sup> In general, the economic theory of legislation has treated Congress as a monopolist, that is, as the sole supplier of legislation to interest groups.<sup>18</sup> This treatment of Congress should strike lawyers as peculiar. In particular, state courts, state legislatures, and federal administrative agencies all appear to be important rivals to the federal government in that they appear to constitute additional potential sources of legislation for interest groups.

Treating Congress as a monolithic supplier of regulation, however, is not as unrealistic as it might appear at first blush. As McGubbins, Noll, and Weingast pointed out in a recent article that already has become a classic, Congress has been able to devise organizational structures and incentive mechanisms that align the interests of the bureaucrats within administrative agencies with their own.<sup>19</sup> In particular, the close oversight of administrative agencies permitted by Congress' committee system and Congress' ability to control budgetary allocations to administrative agencies give it surprisingly tight control over the policy preferences and regulatory outcomes generated by administrative agencies.

Congress also retains considerable power to control the regulatory agenda in the states. Congress can utilize its power under the commerce clause to regulate virtually all aspects of economic life. And, of course, the supremacy clause gives Congress the ability to trump state law on any issue it chooses. Consequently, even though the states continue to serve as the primary source of regulation, the ability of the states to regulate depends almost entirely on Congress' willingness to forbear from regulating.<sup>20</sup> As I have pointed out in another context, Congress will be willing to forbear from regulating if, and only if such forbearance is the best way for Congress to maximize its own political support.<sup>21</sup>

Thus the key to determining the regulatory pattern in a given industry lies in the nature of the preferences of the interest groups that are being

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17. Weingast, *The Political Institutions of Representative Government*, J. INSTITUTIONAL & THEORETICAL ECON., 693, 693 (1989).

18. *Id.*

19. McCubbins, Noll & Weingast, *Structure and Process, Politics and Policy: Administrative Arrangements and the Political Control of Agencies*, 75 VA. L. REV. 431 (1989).

20. Macey, *Federal Deference to Local Regulators and the Economic Theory of Regulation: Toward a Public-Choice Explanation of Federalism*, 76 VA. L. REV. 265 (1990).

21. *Id.*

regulated. These groups will cause Congress either to pass laws directly, or else they will cause it to allocate the regulatory authority over a particular issue to a regulatory agency, such as the SEC, or to the states. The preferences of the interest groups subject to regulation will depend, in large part, on the interest groups' cost of access. An interest group that has established a pattern of repeat dealing with a particular agency is likely to turn to that agency when it needs to obtain a regulatory preference. Similarly, the bureaucracy itself may develop preferences over time. Inevitably these preferences will be tied to the interests of the groups they regulate. This is because agencies can no longer justify their existence if the groups they regulate go out of business. Consequently, acts that threaten the welfare of an interest group also threaten the welfare of its client regulatory agency.

The following section explores the factors that have influenced the allocation of regulation concerning tender offers among the interested sources of regulation: the SEC, the states, and Congress.

## II. SOURCES OF REGULATION

### *A. Congress*

The takeover business is a high stakes game. High stakes games provide Congress with many opportunities to obtain political support both through contributions, and through the publicity that media coverage of congressional proceedings can provide. Thus it is rather surprising that the 1980s produced virtually no takeover legislation of any substance. Congress has remained content to relegate primary regulatory responsibility to the SEC and to the states.

The reason Congress prefers to refrain from regulating in the takeover arena is clear. The costs of such regulation are greater than the benefits. Any doubts about the political cost-benefit calculation associated with federal intervention in the market for corporate control were laid to rest in October 1987 when proposed tax changes that would have severely impeded the market for corporate control triggered the most dramatic decline in shareholder wealth in United States history.

A careful study by Mark Mitchell and Jeffry Netter examines news stories about the proposed legislation that came across the financial news wires shortly before the crash. Using sophisticated financial econometric techniques, Mitchell and Netter are able to pinpoint the exact time the news reached the market. They are then able to show precisely how the



market reacted to the unanticipated news.<sup>22</sup>

During the so-called market break of October 1987, the Dow Jones Industrial Average of New York Stock Exchange listed securities dropped 508 points, and the New York Stock Exchange lost \$1 trillion in value.<sup>23</sup> The decline in the Dow represented a loss of 22.6 percent of the value of that index. This crash, which had begun on Wednesday, October 14, 1987, was the most extreme one-week decline in the market's history.<sup>24</sup> The most promising explanation for the October 1987 events is that the market crash was triggered by proposed tax changes introduced in the House Ways and Means Committee on the evening of October 13, 1987, and approved on the evening of October 15, 1987.<sup>25</sup> These proposed tax changes would have stifled the market for corporate control by reducing the tax advantages associated with making a takeover bid. In particular, the proposed changes in the taxation of corporate control transactions would have limited deductions for interest expenses exceeding \$5 million a year on debt incurred to finance takeovers and leveraged buyouts. The proposed legislation also eliminated the ability of an acquiror to use mirror subsidiaries to dispose of target assets without a recognition of the corporate level gain. Finally, the proposed bill contained:

several provisions specifically designed to restrict hostile takeovers. Interest deductions on any debt used to finance a hostile takeover attempt of over 20 percent of a target's stock or assets would be prohibited. The bill would have required a hostile bidder to treat an acquisition of stock as a purchase of assets with immediate corporate recognition of the difference between the target's basis in its assets and the purchase price. The proposal also included a 50% nondeductible excise tax on profits from greenmail payments.<sup>26</sup>

The stated purpose of the legislation was to prevent hostile acquisitions:

The House Ways and Means [C]ommittee believes that corporate acquisitions that lack the consent of the acquired corporation are detrimental to the general economy as well as to the welfare of the acquired corporation's

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22. Mitchell & Netter, *Triggering the 1987 Stock Market Crash: Antitakeover Provisions in the Proposed House Ways and Means Committee Tax Bill*, 24 J. FIN. ECON. 37, 43-48 (1989).

23. REPORT OF THE PRESIDENTIAL TASK FORCE ON MARKET MECHANISMS (Brady Report) 1, 1 (1988), Special Rep. No. 1267 Fed. Sec. L. Rep. (CCH) (Jan. 12, 1988).

24. Mitchell & Netter, *supra* note 22, at 37.

25. *Id.*

26. *Id.* at 39.

employees and community. The committee therefore believes it is appropriate not only to remove the tax incentives for corporate acquisitions, but to create tax disincentives for such acquisitions.<sup>27</sup>

Far from being detrimental to the general economy, takeovers, particularly hostile takeovers, are in fact highly beneficial to the economy in general and to target firm shareholders in particular.<sup>28</sup> When a takeover attempt is announced, target firm shareholders receive an average takeover premium of twenty-five to thirty-five percent.<sup>29</sup> Recent studies have found average gains to target firm shareholders to be as high as 53.2 percent.<sup>30</sup> These gains to target firm shareholders strongly suggest that takeovers are good for the economy generally. Gains to target firm shareholders suggest either that target firm shares are currently undervalued in the market, or else that the assets of the target firm are capable of attaining a higher value if reorganized or managed by a different management team.<sup>31</sup> In light of the plethora of empirical evidence showing that the capital markets are efficient,<sup>32</sup> the latter explanation clearly emerges as the most convincing:

The restructuring of corporate America . . . that is being brought about by the takeover market is streamlining many of the largest and most complex corporations that are simply too large, too complicated, and too unfocused to be efficient. Restructuring is bringing top level managers closer to employees, customers and shareholders. We must not strangle these productive forces.<sup>33</sup>

The negative effects of legislation imposing prohibitive tax restrictions on corporations are not limited to those individual firms that happen to be involved in takeovers at the particular time the legislation is introduced. As Frank Easterbrook and Dan Fischel have observed, managers of *all* firms have incentives to be more productive if they have reason to believe that a hostile takeover is a possibility. Because managers of acquired firms generally are displaced,<sup>34</sup> the threat of takeover provides

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27. *Id.* (citing legislative history).

28. Macey, *State Anti-takeover Legislation and the National Economy*, 1988 WIS. L. REV. 467.

29. Jensen & Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5 (1983).

30. Comment & Jarrell, *Two Tier and Negotiated Tender Offers*, 19 J. FIN. ECON. 283 (1987).

31. Macey, *supra* note 28, at 471.

32. See Jensen, *Some Anomalous Evidence Regarding Market Efficiency*, 6 J. FIN. ECON. 95 ("there is no other proposition in economics which has more solid empirical evidence supporting it than the Efficient Market Hypothesis").

33. Jensen, *A Helping Hand for Entrenched Managers*, Wall St. J., Nov. 4, 1987, at 36, col. 6.

34. *Id.*

managers with a strong incentive to maximize firm value in order to avoid a hostile acquisition. Thus "shareholders benefit [from tender offer bids] even if their corporation never is the subject of a tender offer. The process of monitoring by outsiders poses a continuous threat of takeover if performance lags. Managers will attempt to reduce agency costs in order to reduce the chance of takeover . . . ." <sup>35</sup>

Thus, it is not surprising that a bill imposing a tax penalty on hostile takeovers would have "wide ranging detrimental effects on stock prices."<sup>36</sup> Consistent with the hypothesis that the antitakeover provisions of the House Ways and Means tax bill triggered the stock market crash, Mitchell and Netter show beyond any reasonable doubt that the market declined on news that the House was likely to impose meaningful restrictions on takeovers, and rose on news that the House was dropping most antitakeover provisions from its tax package.<sup>37</sup>

Mitchell and Netter also show that rival explanations for the stock market decline are less convincing than their antitakeover tax hypothesis. One popular explanation for the crash offered at the time was that it resulted from the Commerce Department's October 14, 1987 announcement of trade-deficit figures for August 1987. The announced deficit of \$15.68 billion was \$0.79 billion smaller than the previous month's deficit of \$16.47 billion, but it was slightly higher than expected. Mitchell and Netter show that little of the decline on October 14 is attributable to the trade deficit announcement.<sup>38</sup> Similarly, news of rising interest rates, or use of program trading strategies, such as portfolio insurance and risk arbitrage, cannot be said to have triggered the crash.<sup>39</sup>

Thus, while members of Congress could garner substantial political support for themselves in exchange for tampering with the market for corporate control, the efficiency of the stock market is such that the negative effects of this tampering would be felt almost immediately. Not surprisingly, this experience dampened Congress' interest in displacing the states from their traditional role as the primary suppliers of corporate

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35. Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1174 (1981).

36. Mitchell & Netter, *supra* note 22, at 40.

37. Mitchell and Netter isolate five discrete event dates when news about the progress of the takeover tax was publicly disclosed. For each of these event dates, *t*-values based on the cross-section variance estimate reject the null hypothesis of zero abnormal performance at the 0.001 level. Mitchell & Netter, *supra* note 22, at 46.

38. *Id.* at 57.

39. *Id.* at 57-59.

law. As long as the political costs from regulating are higher than the political gains, we may continue to expect Congress to search for other ways to meddle in the economy.

This explanation for Congress' willingness to defer regulatory authority to the states is consistent with the trenchant insight made by political scientists such as Morris Fiorina<sup>40</sup> and Kenneth Shepsle:<sup>41</sup> the optimal political strategy for politicians faced with particularly controversial or uncertain legislative issues is to refrain from regulating, either by abstaining altogether, or else by delegating the matter to an administrative agency. And, when a regulatory matter is particularly controversial, the optimal regulatory strategy may be to turn the matter over to the states in order to insulate Congress from the political fallout associated with legislating in that area. This is because "Congress is more likely to be held accountable for regulatory actions taken by administrative agencies than it is for similar actions taken by states. In addition, Congress can justify virtually any decision to delegate a controversial policy matter to the states simply by uttering vague tributes to the virtues of federalism."<sup>42</sup>

### B. *The SEC*

The SEC has consistently taken a *laissez faire* position with regard to the desirability of takeover regulation that essentially reflects the free-market policy preferences of the executive rather than the interventionist proclivities of Congress. Indeed, the SEC went so far as to suggest that shareholders be allowed to opt out of certain provisions of the Williams Act.<sup>43</sup>

The SEC also has taken an activist position as an advocate in courts and state legislatures in support of its position that the market for corporate control should be unregulated.<sup>44</sup> In both *CTS Corp. v. Dynamics*

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40. Fiorina, *Legislative Choice of Regulatory Forms: Legal Process or Administrative Process?* 39 PUB. CHOICE 33 (1982).

41. Shepsle, *The Strategy of Ambiguity: Uncertainty and Electoral Competition*, 66 AM. POL. SCI. REV. 555 (1972).

42. Macey, *supra* note 20, at 285.

43. Concept Release on Takeovers and Contests for Corporate Control: Advance Notice of Possible Commission Actions [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,018 at 88,199 (Mar. 9, 1987).

44. See Palmiter, *The CTS Gambit: Stanching the Federalization of Corporate Law*, 69 WASH. U.L.Q. 445 (1991).

*Corp. of America*<sup>45</sup> and *Edgar v. MITE*,<sup>46</sup> the SEC filed amicus briefs supporting the position that state antitakeover statutes are unconstitutional as violative of the commerce clause. The SEC has publicly decried the wave of state antitakeover statutes that followed *CTS*.<sup>47</sup>

It is, of course, possible that the SEC's opposition to state law restrictions on the market for corporate control simply arises from a principled commitment to a free market ideology. But this is highly unlikely in light of the SEC's opposition to free market solutions to problems in other areas. For example, the SEC long has refused to acknowledge the validity of market-oriented arguments with respect to insider trading issues, and instead has steadfastly clung to the position that insider trading must be banned because it is "unfair."<sup>48</sup> Even more to the point, the SEC consistently has supported the Williams Act,<sup>49</sup> which imposes severe impediments on the market for corporate control by forcing bidders to disclose their identity and plans upon launching a tender offer or within ten days of acquiring five percent of another firm's stock via purchases that do not constitute a tender offer.<sup>50</sup> This requirement severely impedes the operation of the market for corporate control because it deprives potential bidders of much of the incentive to invest the resources necessary to launch a hostile bid for another firm's shares.<sup>51</sup>

It seems likely that the SEC supports the Williams Act restrictions on the market for corporate control at the same time that it opposes state law interference with the market for corporate control because the Williams Act increases the demand for the SEC's services as an administrative agency; state laws regulating the market for corporate control diminish the demand for the SEC's influence. If the states were prohibited from regulating the market for corporate control, interest groups' demand for regulation necessarily would shift from the state legislatures to the SEC. By contrast, if the Williams Act were repealed, then the

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45. 481 U.S. 69 (1987).

46. 457 U.S. 624 (1982).

47. Palmiter, *supra* note 44.

48. See Macey, *From Judicial Solutions to Political Solutions: The New, New Direction of the Rules Against Insider Trading*, 39 ALA. L. REV. 355 (1988).

49. Pub. L. No. 90-439, 82 Stat. 454 (codified as amended at 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1982 & Supp. I 1983)).

50. Though the SEC has suggested that the idea of allowing shareholders to opt out of the Williams Act be considered, no realistic possibility that this suggestion would be adopted ever existed.

51. Fischel, *Efficient Capital Market Theory, The Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1, 9-18 (1978).

demand for the SEC's services as a provider and interpreter of rules would decline. Thus, the agency's desire to expand its bureaucratic turf, rather than a principled economic perspective, informs the SEC's policy positions with respect to the market for corporate control.

Consistent with the interest group perspective to political behavior taken in this Article, it is no surprise that the SEC's policy positions are consistent with the business interests of the SEC's most powerful constituencies—investment bankers and corporate lawyers. These constituencies want to maximize their own revenues, which means that the legal regime governing takeovers must be sufficiently complex so as to create a need for lawyers and investment bankers' services, but not so complex as to reduce the number of deals. Thus, while target firm shareholders would want to maximize the number of successful takeovers by outside bidders, and target firm managers would want to minimize the number of successful bids, the lawyers and investment bankers who comprise the SEC's natural constituency prefer to maximize their own revenues. This requires a regulatory strategy different from the one that either shareholders or managers would prefer. The rules administered by the SEC come far closer to maximizing lawyer and investment banker revenues than the rules promulgated by state legislatures. This is because target managers are a natural constituency of state legislatures, while lawyers and investment bankers are the natural constituency of the SEC.

Thus, demand for the SEC's services would increase if state antitakeover statutes were declared unconstitutional. The SEC would find itself once again in the enviable position of being the dominant supplier of takeover legislation, and this would enable the agency to increase the amount of political support it receives from various groups.

The substantive positions taken by the SEC with regard to the regulation of the market for corporate control both maximize the SEC's aggregate political support from various interest groups and reflect the outcomes that those groups most prefer. The SEC advocates that states adopt efficient rules with regard to the market for corporate control because efficient rules restrict the ability of the states to interfere with the SEC's rule-making prerogatives. But the SEC's regulation of insider trading cannot be justified on the grounds that it promotes the goals of efficiency, fairness, or market integrity. Rather, the regulations promulgated by the SEC "reflect a hodgepodge of special interest concerns."<sup>52</sup>

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52. Macey, *supra* note 48, at 379.

The SEC's recent involvement in the one-share, one-vote controversy that pitted the New York Stock Exchange against certain of its more powerful listed firms provides a useful illustration of this point. The NYSE long had an internal rule that prohibited listed firms from issuing dual class common stock of any kind.<sup>53</sup> During the mid-to-late 1980s, however, the incumbent management of several NYSE listed firms discovered that listing multiple classes of stock with different voting rights provided an effective mechanism for reducing the threat of hostile takeover. In general, a dual class recapitalization would create capital structures with two classes of common stock. One class, held by incumbent managers and their affiliates, would have much higher voting rights than the class held by the public. A dual class recapitalization effectively makes a hostile takeover of the firm virtually impossible because upon completion of the recapitalization, incumbent management and its allies are able to retain control of the target firm's board of directors. For this reason commentators voiced the opinion that "the move toward dual class common stock portends the most important shift in the underlying structure of corporate governance since the rise of institutional stock ownership."<sup>54</sup>

The NYSE firms that proposed to offer two classes of common stock were playing a "chicken game" with the NYSE. These firms realized that the NYSE's only meaningful sanction for breaching its rule against dual class stock was to delist the transgressing firms. The NYSE knew that the loss of revenues associated with such delistings would hurt it at least as much as the firms being delisted. This was particularly true because firms delisted from the Exchange simply could migrate to the over-the-counter market or to the American Stock Exchange, both of which permitted firms to issue multiple classes of common stock.<sup>55</sup> The NYSE appealed to the SEC for its assistance in resolving this controversy. The SEC could have used this opportunity to employ its rulemaking author-

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53. See NYSE LISTED COMPANY MANUAL § 313 (1987). The rule dated from 1926. See Fischel, *Organized Exchanges and the Regulation of Dual Class Common Stock*, 54 U. CHI. L. REV. 119, 120 (1987).

54. See Gordon, *Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 CALIF. L. REV. 1, 4 (1988).

55. The National Association of Securities Dealers, the self-regulatory body that has regulatory responsibility over the over-the-counter markets, placed no limitations on firms' ability to issue dual class stock. The American Stock Exchange permitted firms to issue dual class stock, but listed only those classes with rights to elect 25% of a firm's board of directors. Gordon, *supra* note 54, at 5 (citations omitted).

ity to facilitate the market for corporate control; instead, it adopted rule 19c-4, which reflects a compromise position designed to protect the NYSE, while leaving the states free to permit firms to use dual class stock as a means of thwarting takeovers.<sup>56</sup> Rule 19c-4 prohibits all stock exchanges as well as the National Association of Securities Dealers Automated Quotation System from listing the common stock of any firm that undertakes a recapitalization which reduces the per-share voting rights of any existing common shareholders. But the SEC's rule excludes various takeover defensive mechanisms. In particular, rule 19c-4 excludes state control share acquisition statutes, poison pills, and stock lock-ups, all of which have the effect of creating disproportionate voting rights in certain shareholders, generally by reducing the voting rights of acquirors for the purpose of protecting incumbent management against hostile bidders.

Rule 19c-4 protects the New York Stock Exchange, one of the SEC's most valuable constituent interest groups, but does not prevent incumbent management teams from obtaining some of the benefits of disproportionate voting rights. The SEC could have used its authority to prevent firms from delisting from the Exchange to avoid its rules, but this would have brought down the considerable wrath, not to mention lobbying skills, of business groups such as the Business Roundtable. Alternatively, the SEC could have supported the free-market solution of allowing the various exchanges and the over-the-counter market to adopt whatever rules they see fit and letting the chips fall where they may.<sup>57</sup> But this would have imposed severe costs on the NYSE, and therefore would have cost the SEC valuable political support. In the end, the compromise position reached by the Commission can only be explained as a means of protecting the SEC's own political position at the expense of its principles.

### C. *The States*

The politicization of state corporate law rules is manifest. The high stakes game in corporate law is takeovers. Takeovers help target firm shareholders and the economy in general, but they harm incumbent managers. Takeovers help target shareholders because of the substantial premiums such shareholders enjoy when their firms are subject to a bid.<sup>58</sup>

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56. Securities Exchange Act Rule 19c-4, 17 C.F.R. § 240.19c-4 (1990).

57. Fischel, *supra* note 53, at 121-27.

58. See *supra* text accompanying notes 28-30 (describing takeover premia for target shareholders).



Takeovers enhance the economy by ensuring that ineffective or corrupt incumbent management teams are replaced and that society's resources are channeled to those who are able to employ them in their most productive uses.<sup>59</sup>

By contrast, state statutes that impede the market for corporate control will result in less monitoring of managers of all firms, less efficient deployment of society's resources, and a greater number of corporate bankruptcies and reorganizations.<sup>60</sup> State legislatures have responded to the problem of defensive tactics that transfer wealth from shareholders to managers by impeding the market for corporate control by passing a host of statutes that make these sorts of wealth transfers even easier. State legislatures and incumbent managers have, in effect, ganged up on corporate shareholders in order to deprive them of the benefits of the market for corporate control. The explanation for this is clear. Incumbent management teams represent a powerful in-state lobby, while shareholders are widely dispersed throughout the country.<sup>61</sup> State politicians are only too happy to pass laws that transfer wealth from politically ineffectual, out-of-state shareholders to politically powerful local managers.

At this point it might be tempting to argue in favor of federal preemption of state corporate law, since the federal law of takeovers, while favorable to incumbent managers at the expense of shareholders,<sup>62</sup> generally is less confiscatory than state law, particularly after the recent wave of state antitakeover statutes. But the point of this Article is to argue that this sort of public policy calculus is irrelevant because it ignores the fact that the states have no independent regulatory authority. The states regulate at the pleasure of Congress. Congress has declined to intervene in the states' efforts to impair the market for corporate control because non-intervention benefits Congress politically. In light of the federal government's broad authority under the supremacy clause to preempt local rules,<sup>63</sup> interest group theory predicts that Congress will choose to delegate regulatory issues to the states only when the political support it obtains from deferring exceeds the political support it obtains from regulating itself.<sup>64</sup>

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59. Macey, *supra* note 28, at 485-87.

60. *Id.*

61. See Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111 (1987).

62. Macey, *supra* note 28, at 489.

63. Van Alstyne, *The Second Death of Federalism*, 83 MICH. L. REV. 1709 (1985); *Nine for the Seesaw*, THE ECONOMIST, Mar. 2, 1985, at 21.

64. Macey, *supra* note 20, at 267.

The *reason* that Congress has declined to preempt the states is clearly not because Congress is concerned that it could not regulate as effectively as the states. Rather, the reason Congress forbears from regulating is because it, like the state legislatures themselves, obtains political support for deferring to the states. By deferring to the states on the takeover issue, Congress is able to deflect the responsibility for a set of legal rules that strangle the economy and transfer billions of dollars in shareholder wealth to incumbent management teams. Congress also is able to appease powerful interest groups such as the Business Roundtable, which represents top management at major corporations, and is adamantly opposed to a free market for corporate control.

### III. THE COURTS

The preceding discussion has painted a rather bleak picture of the political process. Bureaucrats, as well as politicians, at both the state and local levels are depicted as self-interested economic actors, trying to advance their own political goals, often at the expense of the disaggregated "general public" they ostensibly were chosen to protect. Bureaucrats depend on politicians for their political survival. Politicians respond to interest group pressures for a number of reasons. Most obviously, political survival requires the economic support of interest groups:

Interest groups influence the political process by such overt methods as promises of political support, campaign contributions, and outright bribes, and by slightly more subtle methods such as investing in congressional retirement funds. Another common method of influence is paying congressmen honoraria for speaking engagements.<sup>65</sup>

In addition to interest groups' ability to influence lawmakers' thinking through financial incentives, such groups also influence the policymaking process by controlling the flow of information to decisionmakers. Much special interest legislation transfers wealth from some disaggregated group (like shareholders) to some other, relatively cohesive group (like incumbent management). The disaggregated individuals paying for the wealth transfers do not have the incentives to invest the resources to mount a lobbying campaign to counter the lobbying of the interest groups. Similarly, of course, the disaggregated individuals who are the suppliers of legislative wealth transfers do not supply policymakers with

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65. Macey, *Promoting Public-Regarding Legislation Through Statutory Interpretation: An Interest Group Model*, 86 COLUM. L. REV. 223, 230 (1986).

information about their positions on various issues. As a result, the interest groups with a stake in a particular legislative wealth transfer program generally will control the flow of information about the issue to the relevant legislators. With regard to complex issues, this control of information enables interest groups "to distort congressmen's thinking on an issue—normally all an interest group needs to achieve its ends."<sup>66</sup> Thus the simple fact that information is costly to obtain and disseminate means that legislators often pass special interest legislation really believing they are acting in the public interest.<sup>67</sup>

The interest group analysis of government behavior is generally accepted among economists and seems hardly controversial. The remaining difficult theoretical and empirical issue concerns the role of the federal courts within the economic theory of legislation. On this issue academics who subscribe to interest group theory appear to divide into two camps. One camp comprises the followers of William Landes and Richard Posner, who claim that the existence of an independent federal judiciary *further*s the ability of special interest groups to transfer wealth to themselves from the population as a whole.<sup>68</sup> In the other camp are those, such as myself, who argue that the independent federal judiciary hinders the ability of special interests to dominate the legislative process.<sup>69</sup>

Landes and Posner recognize that interest groups and politicians who attempt to enter into special interest group bargains face severe contracting problems related to enforceability. In particular, Landes and Posner observe that if the parties to a contract believe that the bargain they are striking is unenforceable, the value of that contract will be significantly diminished. As a consequence, like other contracting parties, interest groups and politicians have a strong incentive to ensure that the deals they strike will be enforceable.<sup>70</sup> Landes and Posner argue that the federal judiciary serves as an independent enforcement mechanism for these deals. Thus, according to Landes and Posner, the independent judiciary facilitates special interest groups' ability to effectuate wealth transfers through the legislative process by providing the "stability or

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66. Easterbrook, *What's Wrong With Congress?*, THE ATLANTIC, Dec. 1984, at 57, 70-72.

67. Macey, *supra* note 65, at 231.

68. Landes & Posner, *The Independent Judiciary in an Interest-Group Perspective*, 18 J. L. & ECON. 875, 894 (1986) (the court's role is to enforce the deals that special interests groups obtain from the legislature).

69. Macey, *supra* note 65.

70. Landes & Posner, *supra* note 68, at 877.

continuity necessary to enable interest-group politics to operate in the legislative arena . . . ."<sup>71</sup>

The ability of legislators to offer special interest groups permanent rather than short-term deals increases the income of legislators who enact such rules. The stability or continuity provided by the federal judiciary in the Landes and Posner model enables members of the current legislature to capture their full share of the present value of a wealth transfer program designed to run in perpetuity, even if they plan to leave the legislature at the end of the current session.<sup>72</sup>

As proof of their theory that federal judges act as enforcers of special interest group bargains, Landes and Posner offer, as an empirical test, evidence that the Supreme Court has only rarely nullified acts of Congress on constitutional grounds. They do not, however, offer any rationale for why article III judges find it to be in their interests to uphold special interest groups' deals with legislatures. After all, these judges cannot be fired and cannot have their salaries reduced during their terms of office. In addition, unlike legislators, these judges do not obtain any tangible benefits from interest groups for acting on their behalf. Thus, it is difficult to imagine what incentive judges have to enforce the deals that interest groups make with politicians.

I elaborate on some of these observations in an article discussing the role of the independent judiciary from an interest group perspective.<sup>73</sup> I argue that federal judges can invalidate interest group deals through the process of statutory interpretation as well as through the process of constitutional invalidation. Judicial invalidation through statutory interpretation allows federal judges to protect the public from the welfare-reducing consequences of legislative wealth transfers without the risk of a direct constitutional confrontation with Congress.

The Supreme Court's decisions on the constitutionality of state laws restricting takeovers provide an extremely useful lens through which to view the response of the Court to interest group legislation promulgated by the states. The Court's major decisions in this area are, of course, *Edgar v. MITE*,<sup>74</sup> and *CTS Corp. v. Dynamics Corp. of America*.<sup>75</sup> In

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71. *Id.* at 878.

72. Aranson, *Judicial Control of the Political Branches: Public Purpose and Public Law*, 4 CATO J. 719, 731-32 (1985) (discussing implications of Landes and Posner's theory).

73. Macey, *supra* note 65.

74. 457 U.S. 624 (1982).

75. 481 U.S. 69 (1987).

1982, the Supreme Court invalidated the Illinois antitakeover statute in *Edgar v. MITE*, and in 1987 the Supreme Court validated an Indiana antitakeover statute at least as confiscatory as the Illinois statute.

Taken together, these decisions present a coherent picture of the Supreme Court's attitude towards special interest group oriented legislation that is remarkably coherent and profound. Essentially, the Court is saying that states can pass inefficient statutes that impede the market for corporate control, but that doing so will not be costless. State legislatures must be very careful to dot their *i*'s and cross their *t*'s. Put another way, the Court is prepared to raise the costs that interest groups and politicians must bear to obtain special interest group deals, but it is not prepared to make such deals unconstitutional (that is, infinitely costly).

A plurality of the Supreme Court found three aspects of the Illinois statute at issue in *Edgar v. MITE* to be objectionable on the grounds that they directly conflicted with the Williams Act. First, the Court objected to a provision in the statute that required outside offerors to provide incumbent management with twenty days advance warning of a prospective bid. During this twenty day period, incumbent management would be allowed to communicate its views on the impending offer to shareholders, but the offerors could not publish their offers.<sup>76</sup> This provision was held invalid because it tipped the balance of power in takeover battles too heavily in favor of incumbent management. Particularly persuasive to the Court on this issue was the fact that Congress expressly had considered and rejected proposals to impose precommencement disclosure requirements on bidders on the grounds that such requirements harmed shareholders.<sup>77</sup>

The second flaw in the Illinois statute under review in *MITE* concerned the Illinois Secretary of State's statutory right to call a hearing with respect to any tender offer. Under the statute, whenever the Secretary of State called a hearing, the offer would not be allowed to proceed until the hearing was completed. The statute allowed the Secretary to call a hearing at any time prior to the commencement of the offer, but provided no deadline for the completion of the hearing.<sup>78</sup> This, of course, allowed management "to stymie indefinitely a takeover."<sup>79</sup> The Court, recognizing that delay raises the costs of making an offer, rea-

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76. *MITE*, 457 U.S. at 630-35.

77. *Id.* at 635.

78. *Id.* at 637.

79. *Id.*

soned that the hearing provisions of the Illinois statute conflicted with the Williams Act because the federal law was designed to ensure that "investors and the takeover offeror would be free to go forward without unreasonable delay."<sup>80</sup>

Finally, the plurality in *MITE* objected to the fact that the statute's hearing provisions permitted the Secretary of State to pass on the substantive fairness of the offer at the hearing and to deny registration of a tender offer if he found that the offer was "inequitable." The Court found this provision to be objectionable because it interfered with investor autonomy by depriving shareholders of their right to make their own decisions with respect to a tender offer.<sup>81</sup>

On the preemption issue, the Court recognized that it was possible to comply with both the provisions of the Williams Act and the provisions of the Illinois law, but that the Illinois statute frustrated the objectives of the Williams Act in a substantial way.<sup>82</sup> Congress interpreted the Williams Act as a measure to protect investors. The Court noted that it was "crystal clear that a major aspect of the effort to protect the investor was to avoid favoring either management or the takeover bidder."<sup>83</sup> In fact, it seems clear that the Williams Act is not in fact evenhanded. Rather, the Act transfers wealth from shareholders of bidding firms to shareholders of target firms and aids incumbent management of target companies in their efforts to remain independent.<sup>84</sup>

In other words, the Williams Act represents a special interest group oriented statute designed to benefit incumbent management. But the Court did not treat the statute like a special interest statute. The Court treated the statute as though it were public-regarding, and on this basis held that the Illinois statute was in conflict with it. Like many other statutes, the interest group orientation of the Williams Act is not immediately apparent on the statute's face or from its legislative history.<sup>85</sup> Special interest legislation often is drafted with a public-regarding gloss in order to raise the costs to the public—and to rival groups—of discovering the true effects of the legislation.<sup>86</sup> As Cass Sunstein has observed,

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80. *Id.* at 639.

81. *Id.* at 639-40.

82. *Id.* at 626.

83. *Id.* at 633.

84. Fischel, *supra* note 51, at 13-14; Macey & Netter, *Regulation 13D and the Regulatory Process*, 65 WASH. U.L.Q. 131 (1987).

85. See Macey, *supra* note 65, at 251-56.

86. *Id.*

a legislature often will engraft a "public value" onto a statute in order to "justify the exercise of governmental power."<sup>87</sup>

Layering a special interest group oriented statute with a public interest gloss reduces the special interest groups' cost of persuading the legislature to vote for the special interest legislation because it reduces the legislators' cost of supporting the legislation. By taking the statute's articulated public purpose at face value, the Court, as it did in *MITE*, often frustrates the efforts of special interest groups before the judiciary. By interpreting the Williams Act as an even-handed statute rather than as a pro-management statute, the Court found a conflict between the publicly articulated purposes of the Williams Act and the effects of the Illinois statute.

Thus, *MITE* clearly exemplifies the Court's use of traditional techniques of statutory interpretation to produce results that thwart the ability of legislatures to make deals with special interest groups. Unfortunately for shareholders, in *CTS*, the Supreme Court did not find a conflict between the provisions of the Williams Act and the provisions of the Indiana Control Share Acquisition Statute. A twenty day advance warning requirement was not available, and the statute did not empower state officials to call hearings either to evaluate the merits of the offer or to delay it. Instead, the Indiana legislature structured the statute so as to prevent outside bidders from obtaining voting rights for the stock they purchased, unless a majority of the investors who held target firm shares prior to the outside offer voted to restore voting rights to the shares.

Unlike the Illinois statute at issue in *MITE*, the Indiana statute was found to protect "the independent shareholder against the contending parties. Thus, the Act furthers a basic purpose of the Williams Act, 'plac[ing] investors on an equal footing with the takeover bidder.'"<sup>88</sup>

In addition, the Court in *CTS* was impressed by the fact that the legislature had left the locus of decisionmaking power in the hands of the shareholders, rather than in the hands of a third party, such as the Secretary of State.<sup>89</sup> The fact that the Indiana statute was drafted to look like a generic provision of state corporate law that regulated the voting rights of shareholders and other strictly internal matters also seems significant.<sup>90</sup> The Court opined that these sorts of issues traditionally have

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87. Sunstein, *Naked Preferences and the Constitution*, 84 COLUM. L. REV. 1689, 1697 (1984).

88. *CTS*, 481 U.S. at 82.

89. *Id.* at 83-84.

90. *Id.* at 85-87, 93-94.

been relegated to the states and was reluctant to interfere with the ability of the states to define the rights and powers of locally chartered firms.<sup>91</sup>

Thus, the Court gave more latitude to the Indiana legislature than it would have given to an administrative agency, such as the SEC, if it had attempted to promulgate a statute that conflicted with the Williams Act. For example, in *SEC v. Chestman*,<sup>92</sup> two judges on the United States Court of Appeals for the Second Circuit invalidated SEC rule 14e-3, which attempted to interpret the Williams Act so as to interfere with the market for corporate control by preventing people "in possession of material, non-public information relating to a tender offer" from trading on that information, even when such trading was not in violation of a fiduciary duty.<sup>93</sup> One judge concluded that the SEC exceeded its statutorily granted authority by promulgating rule 14e-3 without any requirement of a breach of a fiduciary duty.<sup>94</sup> The other judge simply rewrote rule 14e-3 so as to contain a fiduciary duty requirement.<sup>95</sup>

Rule 14e-3 had the potential to interfere with the market for corporate control by preventing market analysts and other market professionals from trading on non-public information obtained from a tender offeror when no breach of a fiduciary duty had occurred. Rule 14e-3's potential for disrupting the market for corporate control was far less severe than that presented by the Indiana statute in *CTS*, which could be used so as to deprive a bidder of the right to vote the shares he acquired in a hostile tender offer.

My purpose here is not to argue that the federal courts are acting as a solid bastion against interest group wealth transfers. Rather, the point is that the courts do not simply rubber stamp the deals that Congress and interest groups contrive together. Subject to what is undeniably an excessive deference to the integrity of the legislative process, the courts often thwart wealth transfers to interest groups by taking the legislature at its word when it enacts statutes that claim to serve a public purpose. The courts are unwilling, however, to substitute their own independent economic judgment for that of the legislature. In *CTS*, the Court was faced with competing policy arguments over the efficacy of hostile takeovers. On one hand, the state of Indiana was arguing that its statute

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91. *Id.* at 91.

92. 903 F.2d 75 (2d Cir. 1990).

93. 17 C.F.R. § 240.143(a) (1990).

94. 903 F.2d at 86.

95. *Id.* at 88.



served the public interest by prohibiting coercive takeovers. On the other hand, the appellee Dynamics Corporation was arguing that the prospect of coercive offers is illusory and that tender offers generally should be favored because they benefit society by reallocating corporate assets into the hands of those management teams who can use them most effectively.<sup>96</sup>

In evaluating these opposing arguments, the Court refused to do any analysis of the merits of either position, but rather accepted the opinion of the Indiana legislature that the threat of coercive offers was a legitimate threat that outweighed the benefits of an unfettered market for corporate control.<sup>97</sup> In his concurrence, Associate Justice Scalia provided the most succinct statement of the Supreme Court's views on the advisability of second guessing otherwise constitutional economic statutes when he said that "a law can be both economic folly and constitutional."<sup>98</sup> While this willingness to defer to the legislature clearly restricts the Court's role in blocking special interest legislation, it does not completely destroy the role of the courts in protecting the public against such deals. As seen above, the courts' commitment to traditional methods of statutory interpretation effectively raises the costs to interest groups of effectuating wealth transfer legislation by raising the likelihood that outcomes such as those in *Chestman* and *MITE*, which invalidated welfare reducing interest group legislation, will be reached.

Results like *CTS*, of course, demonstrate the point made by Landes and Posner that federal judges have declined to use their constitutional powers to thwart interest group oriented deal making. But in order to get a favorable result in *CTS* in 1987, incumbent management had to go through a long and costly process, whose outcome was by no means certain, particularly after the decision in *MITE*. Despite the unfortunate outcome, the process itself was welfare enhancing in several respects. First, the uncertainty associated with these statutes made them less valuable to interest groups. Most states did not enact confiscatory antitakeover statutes until after the *CTS* decision.<sup>99</sup> This delay permitted hundreds of welfare enhancing takeovers to go forward that would have been blocked much earlier in the absence of the possibility of judicial invalidation. In addition, the judicial scrutiny to which state antitake-

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96. *CTS*, 481 U.S. at 92.

97. *Id.*

98. *Id.* at 96-97.

99. Macey, *supra* note 28, at 468.

over statutes have been subjected has served the valuable purpose of providing information about the welfare reducing attributes of these statutes. This information has been of use to shareholders who are more likely to object to adoption of antitakeover statutes as a result of having been informed of their consequences as a result of court decisions.

Similarly, the negative publicity afforded by a court decision discussing the fact that these statutes serve to entrench incumbent management also may have a beneficial effect. Most state antitakeover statutes permit firms to opt out of their provisions. It seems probable that the information and publicity that has accompanied court decisions on takeover statutes has caused more firms to opt out of the provisions of these statutes than would otherwise have been the case. Thus, even the modest intrusions into the legislative process currently being undertaken by courts has some salutary effects on politicians.

#### IV. CONCLUSION

Undoubtedly, Congress could use its constitutional authority under the commerce clause to preempt state corporate law entirely. Indeed influential commentators have advocated that Congress do just that.<sup>100</sup> This Article has not addressed the interesting and important normative question of whether federal law should displace state law. It has not asked the equally interesting normative question of whether (or how far) the SEC should be allowed to encroach on the traditional lawmaking authority of the states. Instead, this Article has addressed what I hope is the equally interesting and important, albeit positive question of *why* we observe the particular allocation of authority that we do. I have argued that Congress has refrained from preempting the field not out of some altruistic, public-regarding notion that federalism serves the interests of society generally or corporate shareholders in particular; rather, I argue that the ability to confer or withhold regulatory authority from state officials is a considerable source of gain to politicians at the national level. Congress, in other words, obtains political support from deferring regulatory authority to the states.

Similarly, I argue that the regulations promulgated by the SEC do not take the shape that they do because of any independent policy assessment by SEC bureaucrats on the general merits of a particular regulatory

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100. R. NADER, M. GREEN & J. SELIGMAN, *TAMING THE GIANT CORPORATION* (1976); Jennings, *Federalization of Corporation Law: Part Way or All the Way?*, 31 BUS. LAW. 991 (1976).

scheme. Rather, the SEC regulates in order to serve the interest groups that compose its regular constituency. In particular, the SEC is attuned to the needs of market professionals and to the needs of the organized exchanges with whom the Commission has established a pattern of repeat dealings over time.

The states and the courts also fit the interest group framework of this Article. The states are captured by incumbent management teams of the public corporations chartered within their borders. The antitakeover regimes that have become a central part of the corporate legal landscape serve the interests of this group. These statutory schemes are contrary to shareholder interests and to the economy as a whole, but the state legislators are indifferent to these costs. This indifference stems from the politicians' ability to keep the benefits of these antitakeover statutes within the borders of their states, while distributing the costs to taxpayers and shareholders scattered throughout the country. Any state that passed a takeover law that served shareholder interests rather than management interests would simply be transferring wealth from local interest groups to society generally. This would be political suicide.

Thus, the regulatory pattern that we observe is one that is completely contrary to any conceivable public interest view of federalism.<sup>101</sup> Under any respectable public interest view of federalism, a state should not regulate so as to transfer wealth to its own citizens from citizens of other states. And yet this is precisely the pattern that we observe in our federalist system.

The single bright spot in the analysis presented here concerns the role of the federal courts. The fact that federal judges are removed from the political process means that, unlike politicians, they do not stand to gain from passing statutes that benefit interest groups at the expense of the public at large. As a consequence, the independent judiciary imposes subtle costs on interest groups that seek to use the legislative process to transfer wealth to themselves from the rest of society. While these costs are not prohibitive to interest groups seeking wealth transfers, the fact that such costs exist means that, at the margin, we observe less welfare reducing legislation than we would in the absence of an independent judiciary.

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101. McConnell, *Federalism: Evaluating the Founders' Design* (Book Review), 54 U. CHI. L. REV. 1484 (1987) (describing public interest justifications for federalism).

